

THE INTERPLAY BETWEEN ESG PERFORMANCE, FIRM VALUE, AND SHARĪ‘AH COMPLIANCE IN INDONESIA

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ABSTRACT

Purpose — Understanding how Environmental, Social, and Governance (ESG) practices interact with firm value within the framework of Sharī‘ah compliance is essential, as Islamic capital markets integrate financial objectives with ethical and sustainable principles. The present study focuses on the bidirectional relationship between ESG performance and firm value. It investigates the moderating role of Sharī‘ah compliance and examines the effect of external governance mechanisms on ESG practices in Sharī‘ah-compliant firms in the context of Indonesia.

Design/Methodology/Approach — The final sample consists of 155 public firms listed in the Indonesia Sharia Stock Index (ISSI). Structural Equation Modelling using Partial Least Squares (SEM-PLS) is employed to test the hypothesised relationships.

Findings — The study finds a significant negative effect of ESG performance on firm value, suggesting that ESG investments may incur short-term costs that reduce immediate market valuation. In contrast, firm value significantly and positively influences ESG performance, indicating that firms with stronger financial standing are more likely to invest in sustainability initiatives. While Sharī‘ah compliance does not moderate the relationship between ESG and firm value, it was found that it positively affects ESG engagement, reflecting the close alignment of Islamic values with sustainability. The study also reveals that external governance factors do not have a significant impact on ESG performance.

Originality/Value — This study extends prior ESG research by modelling the ESG-firm value relationship as a bidirectional process and introducing Sharī‘ah compliance as a moderator variable, thereby offering new insights into ethical investing and sustainable finance in Islamic capital markets.

Research Limitations/Implications — The study adopts a cross-sectional design, which limits the ability to capture longitudinal dynamics and sectoral variations.

Practical Implications — The study offers practical insights for managers, regulators, and investors by demonstrating how ESG engagement with Sharī‘ah constraints may involve short-term value trade-offs while shaping sustainability outcomes in Islamic capital markets.

Keywords — Bidirectional relationship, Environmental, Social, and Governance (ESG), Firm value, *Maqāṣid al-Sharī‘ah*, Sharī‘ah compliance, Sharī‘ah-compliant firms

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INTRODUCTION

In recent years, focus on ESG performance has grown among investors and regulators, as ESG has increasingly become a key element of corporate strategy (Özer *et al.*, 2024; Zumente & Bistрова, 2021). ESG principles have moved to the forefront of corporate behaviour as companies have been facing increasing pressure to adopt sustainable and socially responsible practices. This trend is particularly apparent in emerging markets and developing economies (Dung *et al.*, 2024; Hluszko *et al.*, 2024), where ESG adoption is still maturing and governance frameworks are evolving (Singhania & Saini, 2023). Indonesia, being one of the largest emerging economies, reflects the global shift towards sustainability, with the concept being endorsed in line with Shari'ah values, thus aligning with ESG and Islamic finance principles (Asutay *et al.*, 2023; Gati *et al.*, 2024).

Despite the global emphasis on ESG performance for corporate value creation, there remain at least two significant gaps unexplored in Indonesia's emerging Islamic markets. First, empirical evidence predominantly indicates that robust ESG performance tends to enhance firm value (Desai 2024; Hanh & Truong, 2023; Lee & Isa, 2023). Conversely, the high implementation costs associated with ESG may prompt a short-term reduction in value (D'Costa *et al.*, 2024; Fahad & Busru, 2021). Rastogi *et al.* (2024) documented a nonlinear relationship between ESG and corporate value creation, presenting a compelling opportunity to further investigate whether the link between firm value and ESG, particularly in the context of Indonesia, is unidirectional or bidirectional. Most previous studies have in fact examined the relationship in one direction only, usually focusing on how ESG affects firm value. Few studies explicitly test whether firm value may also influence ESG. This study addresses this gap by modelling the relationship between ESG and firm value as bidirectional within a Shari'ah-compliant context. Second, Shari'ah-compliant firms operate under financial restrictions, especially limits on interest-bearing debt. Since ESG initiatives often require substantial funding, these constraints (e.g., the limited availability of Shari'ah-compliant green financing or the higher costs associated with Islamic capital) may affect how ESG investments translate into firm value, particularly when conventional interest-bearing debt is prohibited. Whether such capital structure restrictions moderate the ESG-firm value relationship remains underexplored.

The synergy between ESG and Islamic finance principles is embodied in the establishment of the Indonesia Sharia Stock Index (ISSI), which promotes ethical and socially responsible investment practices. This study is motivated by the growing ESG awareness within Shari'ah-compliant firms (Ariff *et al.*, 2023), particularly in Indonesia (Khattak *et al.*, 2021; Qoyum *et al.*, 2022). While ESG is acknowledged globally as an essential element of sustainable value creation, the first objective of this study is to examine whether the positive impact of ESG on firm value holds in the context of Indonesian Shari'ah-compliant firms.

Strong ESG performance is generally expected to boost corporate reputation, attract ethically-driven investors, and ultimately enhance firm value. Meanwhile, higher-value firms may be more capable of investing in ESG initiatives given greater access to resources. Understanding this mutual influence is critical, forming the second objective of this study: to explore the effect of firm value on ESG performance.

The literature has yielded mixed results on this issue. Using Islamic banks in Gulf Cooperation Council (GCC) countries, Al-Khouri and Basith (2022) showed a dynamic, bidirectional relationship, suggesting that ESG investments might erode short-term profits, but firms with strong performance typically have a greater propensity to continue investing in ESG. Similarly, Behl *et al.* (2022) noted that the relationship is not uniformly bidirectional, with varying effects depending on time lags, thus highlighting the complexity of this interaction.

Moreover, Wedajo *et al.* (2024) emphasised that ESG scores tend to have a more substantial and consistent long-term impact on firm value than the reverse.

Nonetheless, integrating ESG principles into a Shari'ah-compliant framework presents significant challenges—particularly in finance, where interest-based (*ribā*) transactions are prohibited and ethical business conduct is essential according to Islamic principles (Abbas *et al.*, 2024; Zain *et al.*, 2024). ESG initiatives often require additional financial support, which is frequently available in the form of conventional debt financing. This raises concerns about the potential misalignment with Islamic principles, which strictly prohibit *ribā*. Furthermore, certain ESG criteria, such as absolute freedom of expression and association, may conflict with Shari'ah values (Haji Wahab *et al.*, 2024). Shari'ah-compliant firms bear additional ethical obligations, which can both enhance and hinder ESG performance (Malik *et al.*, 2024). Hence, the third objective of this study is to investigate how Shari'ah compliance moderates the ESG–firm value relationship.

In addition, it is essential to consider external governance factors that influence ESG performance, as these elements shape a firm's ability to meet sustainability targets within a Shari'ah context. Thus, the fourth objective of this study is to analyse the role of external governance, such as regulatory requirements, creditor demands, and public pressure, on ESG outcomes. External governance factors such as regulations play a key role in driving corporate ESG behaviour by mandating disclosures, encouraging sustainable innovation, and shaping investor decisions (Harjoto & Wang, 2024; Nie *et al.*, 2024). Creditors also influence ESG adoption by imposing green lending requirements and offering incentives tied to sustainability (Amosh *et al.*, 2024). Public awareness further contributes by increasing demand for transparency and accountability, supported by media attention and societal expectations (Moalla & Dammak, 2022).

This study puts forward two innovative concepts:

1. The introduction of Shari'ah compliance as a moderating variable in the relationship between ESG and firm value. Although numerous studies have examined ESG and firm performance, few have explored how Islamic values interact with ESG principles, especially in emerging markets. By assessing Shari'ah compliance as both a constraint and an enabler, this research provides new insights into ethical investing and sustainable growth in Islamic finance.
2. Investigating the bidirectional interaction between ESG and firm value. This perspective offers a deeper understanding of how improvements in ESG might influence firm value, and vice versa, within the unique constraints of Shari'ah-compliant operations, while also providing a foundation for future research on sustainable finance in emerging markets.

The remainder of this paper is organised as follows. The next section reviews relevant literature and develops the hypotheses. This is followed by the research methodology, which outlines the data, variables, and analytical approach. The subsequent section presents the empirical findings and a discussion. Finally, the paper concludes by highlighting key contributions, implications, and suggestions for future research.

LITERATURE REVIEW

Legitimacy Theory and ESG

Legitimacy theory suggests that organisations align operations with social norms to maintain approval and sustainability, serving as a basis for engaging in ESG practices (Suchman, 1995).

ESG implementation enables firms to signal ethical conduct, environmental responsibility, and transparency, thus mitigating reputational risk and reinforcing legitimacy (Rahman & Alsayegh, 2021). Companies with strong ESG performance are often viewed as more legitimate, which enhances financial performance and market value by fostering goodwill and reducing regulatory scrutiny. In contrast, companies with low ESG performance sometimes engage in greenwashing by feigning concern about sustainability to maintain a reputable public image. However, this does not always affect financial performance (Lee & Raschke, 2023). In response to ESG-related crises, such as negative media coverage, firms often improve sustainability assurance quality to rebuild trust and restore legitimacy (Emma *et al.*, 2024). Thus, legitimacy theory provides a valuable framework for understanding how firms strategically engage in ESG practices to align with stakeholder expectations and ensure ongoing acceptance within society.

***Maqāṣid al-Sharī'ah* and ESG**

Maqāṣid al-Sharī'ah (the objectives of Islamic law) provides a holistic ethical framework that emphasises human well-being, environmental stewardship, and social justice. The five primary objectives of *maqāṣid al-Sharī'ah*—namely the protection of faith (*dīn*), life (*nafs*), intellect (*'aql*), lineage/family (*naṣl*), and property/wealth (*māl*)—align closely with the core principles of ESG (Anwar *et al.*, 2021). This framework underscores the importance of practices that safeguard the environment, promote social equity, and ensure ethical governance, thus reflecting the fundamental values of Islamic ethics. According to Sheikh and Hussain (2024), *maqāṣid al-Sharī'ah* represent Islam's holistic view of life, encompassing both individual and societal well-being, thereby establishing its relevance to modern sustainability efforts, such as ESG. In practice, the integration of *maqāṣid al-Sharī'ah* into business operations, such as Sharī'ah-compliant investment screening, ensures the exclusion of unethical activities, such as interest (*ribā*), excessive uncertainty (*gharar*), and gambling (*maysir*). This screening resembles ESG criteria but is more explicitly grounded in preventing societal harm. The convergence of ESG and *maqāṣid al-Sharī'ah* not only enhances corporate reputation and stakeholder trust, but also attracts ethically-conscious investors (Zain *et al.*, 2024).

Impact of ESG Performance on Firm Value in Sharī'ah-compliant Firms

The relationship between ESG performance and firm value has gained substantial attention in sustainability research, with numerous studies affirming that strong ESG practices enhance corporate reputation, attract socially responsible investors, and support long-term value creation. While ESG disclosures generally show a positive impact on firm value, especially in environmental and social aspects (Desai, 2024; Hanh & Truong, 2023), some findings reveal more heterogeneous results, such as negative effects on operating performance and return on equity (D'Costa *et al.*, 2024). Moreover, recent evidence suggests a nonlinear, U-shaped relationship, where ESG significantly enhances firm value only at higher performance levels, and this effect is moderated by ownership structure (Bagh *et al.*, 2024; Rastogi *et al.*, 2024). In the context of Sharī'ah-compliant firms, ESG performance resonates with Islamic finance principles that promote ethical conduct and sustainable development (Asutay *et al.*, 2023; Qoyum *et al.*, 2024). ESG integration enables these firms to align their operations with ethical values, appeal to socially-conscious investors, and reinforce firm value (Gati *et al.*, 2024). Additionally, ESG adoption strengthens their position in the ethical investment market by meeting the demand for socially responsible financial products (Khattak *et al.*, 2021). Therefore, it is reasonable to hypothesise that:

H₁: ESG performance positively influences the firm value of Sharī'ah-compliant companies.

Bidirectional Relationship between ESG Performance and Firm Value in Shari'ah-compliant Firms

There may exist a mutual influence between ESG performance and firm value in a dynamic, bidirectional relationship. While stronger ESG performance is expected to enhance firm value, as proposed in the first hypothesis, it is also possible that an increase in firm value could enable greater investment in sustainability practices, creating a feedback loop (Al-Khouri & Basith, 2022; Behl *et al.*, 2022; Li *et al.*, 2018). In the context of ESG disclosure, this feedback loop may further increase the incentives of the manager to improve the internal control mechanisms for regulatory compliance and serve the stakeholders' interests, thus increasing firm value in the long run. Al-Khouri and Basith (2022) described the complex interplay between ESG performance and firm value, where the impact of ESG investments on profitability may take time to materialise. In the case of Shari'ah-compliant firms, these investments are made with long-term ethical considerations in mind, which may not immediately translate into higher profits. As Behl *et al.* (2022) emphasised, however, strong financial performance encourages further investment in ESG initiatives, potentially creating a cycle where increasing firm value leads to better ESG practices. Although previous studies on this bidirectional relationship are still limited, the logic remains compelling: strong ESG performance improves firm value, which, in turn, provides increased resources to further enhance ESG practices, creating a sustainable and mutually reinforcing cycle. Hence, this study proposes the following hypothesis:

H₂: The firm value of Shari'ah-compliant companies positively impacts ESG performance.

Moderating Role of Shari'ah Compliance in the Relationship between ESG Performance and Firm Value

While ESG practices are generally associated with higher firm value, this relationship becomes more complex in the Shari'ah-compliant context due to potential conflicts between conventional ESG financing mechanisms, such as interest-based debt, and Islamic principles (Malik *et al.*, 2024; Zain *et al.*, 2024), thereby introducing unique constraints in aligning with broader sustainability agendas (Abbas *et al.*, 2024). Empirical evidence suggests that Shari'ah compliance can enhance the positive impact of ESG on firm value. For instance, dual ESG and Islamic screening has been associated with improved financial performance, as ethical alignment promotes stakeholder trust (Lee & Isa, 2023). Moreover, Shari'ah-compliant firms tend to hold more cash to fund ESG initiatives without relying on interest-bearing loans, reflecting a commitment to responsible financial management (Ariff *et al.*, 2023). Integrating ESG into Shari'ah-based operations also contributes to reducing market risks, helping firms overcome operational limitations while improving overall performance (Hassan *et al.*, 2021). These findings support the view that Shari'ah compliance not only guides ESG implementation but also strengthens its influence on firm value, thereby positioning it as a moderating factor in this relationship. Thus, it is hypothesised that:

H₃: Shari'ah compliance moderates the relationship between ESG performance and firm value.

Influence of External Governance Factors on ESG Performance in Shari'ah-compliant Firms

External governance factors, such as regulatory pressures, creditor expectations, and public awareness, play a significant role in shaping ESG performance. Regulatory frameworks that mandate ESG disclosures, creditor policies that reward sustainable practices, and societal demands for corporate responsibility—all influence how firms approach sustainability initiatives (Mooneepen *et al.*, 2022; Nie *et al.*, 2024). In Shari'ah-compliant firms, these

external forces may operate within the boundaries of Islamic finance principles, requiring firms to adapt their ESG strategies accordingly. Research by Harjoto and Wang (2024) emphasised the influence of regulatory frameworks on corporate ESG practices, which can either encourage or mandate companies to adopt more sustainable practices. For Sharī'ah-compliant firms, the introduction of regulations that integrate both sustainability and ethical investment principles may promote greater alignment with ESG goals. Similarly, external pressure from creditors, as highlighted by Guo *et al.* (2023), encourages firms to adopt green credit guidelines, which may also be consistent with Sharī'ah compliance if the financing is structured according to Islamic principles. Public awareness and societal expectations, as noted by Moalla and Dammak (2022), also push firms to become more transparent in their ESG disclosures, thereby influencing performance. Accordingly, this study hypothesises that:

H₄: External governance mechanisms influence the ESG performance of Sharī'ah-compliant firms

Research Gap

Although many studies have explored the relationship between ESG and firm value, several gaps persist. First, most previous studies examine the ESG-firm value relationship in conventional firms and developed markets, with limited evidence from Sharī'ah-compliant firms in emerging economies such as Indonesia. Second, the relationship between ESG and firm value is tested dominantly using unidirectional models, whereas potential bidirectional dynamics remain underexplored. Third, while Islamic screening and ESG principles share ethical foundations, limited studies have examined whether Sharī'ah compliance strengthens the ESG-firm value relationship. Fourth, the role of external governance pressures in shaping ESG performance within a Sharī'ah-compliant context has received limited empirical attention.

This study addresses these gaps by examining the bidirectional relationship between ESG performance and firm value in Sharī'ah-compliant firms, testing the moderating role of Sharī'ah compliance and analysing the external governance pressures. By integrating legitimacy theory and *maqāṣid al-Sharī'ah*, this study contributes to the literature on both ESG and the Islamic capital market.

METHODOLOGY

The study examines firms listed in the Indonesian Sharia Stock Index (ISSI), totalling 574 firms as at December 2023. The analysis uses cross-sectional data for the year 2023. This period is particularly relevant as it follows the Indonesian's carbon trading under Financial Service Authority Regulation - POJK No.14/PJK.04/2023, following the Presidential Regulation No. 98/2021 on Carbon Economic Value. The year 2023, therefore, represents a critical regulatory milestone, allowing the study to assess how Sharī'ah-compliant firms respond to the regulations through their ESG disclosure. ESG variables were collected from stand-alone sustainability reports and sustainability sections within annual reports for some firms, while financial variables were obtained from audited financial statements and market database. Firms with incomplete disclosures were excluded, resulting in a final sample of 155 companies.

As presented in **Table 1**, the study measures its variables using two types of data extraction. First, numerical measures such as return on assets (ROA), Tobin's Q, leverage, firm size, percentage of independent commissioners, and total of carbon emission (CO₂) were taken directly from sustainability reports, annual reports and market data based on standard formulas. Meanwhile, external governance variables—namely, regulatory pressure, social pressure, international pressure and creditor pressure—as well as audit quality, industry type, Sharī'ah-compliant investment, and Islamic financial instruments that may appear in narrative

disclosures were coded into quantitative measures (dummy values) through a content analysis procedure.

The dataset underwent several screening procedures. Observations with missing values were removed and outlier tests were performed. The cleaned data were analysed using Structural Equation Modelling-Partial Least Squares (SEM-PLS), which was employed to test all the research hypotheses. SEM-PLS was chosen due to its ability to model complex relationships among latent variables while accommodating non-normal data distributions and small-to-moderate sample sizes (Hair *et al.*, 2017). This method is particularly effective for predictive model and theory development, as it focuses on maximising explained variance rather than achieving overall model fit. SEM-PLS enables the simultaneous estimation of multiple relationships, reducing the risk of bias from separate regression analyses and enhancing the robustness of the findings (Sarstedt *et al.*, 2020).

SEM-PLS consists of two stages: the measurement model and the structural model. In the measurement stage, reliability indicator, internal consistency, convergent validity and discriminant validity were evaluated. Only indicators that satisfied the validity and reliability criteria were retained and subsequently tested in the structural model to obtain the final estimated model.

Table 1: Variable Operationalisation and Measurement

Variable / Dimension	Measurement	Reference
Environmental (E)		
Carbon Emissions (CE)	Total CO ₂ emissions disclosed in the annual report	Mehmood <i>et al.</i> (2024)
Energy Efficiency (EE)	Energy consumption divided by revenue	Yu <i>et al.</i> (2024)
Social (S)		
Employee Welfare (EW)	Employee turnover rate	Zhang <i>et al.</i> (2024)
Community Engagement (CE)	Total CSR expenditure and charitable contributions	Martiny <i>et al.</i> (2024)
Customer Satisfaction Index (CSI)	Customer satisfaction index (0–1)	Smith <i>et al.</i> (2025)
Women on the Board (WOB)	Ratio of female directors to total board members	Tumewang <i>et al.</i> (2024)
Ethnic Minorities on the Board (EOB)	Ratio of ethnic minority directors to total board members	Tumewang <i>et al.</i> (2024)
Governance (G)		
Board of Commissioner Structure (BCS)	Ratio of independent commissioners to total commissioners	Zulfikar <i>et al.</i> (2020)
Ownership Concentration (OC)	Ratio of shares held by major shareholders (>5%)	Hasmi <i>et al.</i> (2024)
Audit Quality (AQ)	Dummy variable: 1 = Big Four auditor; 0 = otherwise	Nguyen & Nguyen (2024)
Audit Committee Meeting Frequency (ACMF)	Number of audit committee meetings per year	Ha (2022)
Firm Value (FV)		
Tobin's Q	Market value of firm divided by replacement cost of assets	Aydoğmuş <i>et al.</i> (2022)
Market-to-Book Value	Market value of equity divided by book value of equity	Rastogi <i>et al.</i> (2024)
Return on Assets (ROA)	Net income divided by total assets	Chakkravarthy <i>et al.</i> (2023)
Stock Price Volatility (SPV)	Standard deviation of daily stock returns	Thi <i>et al.</i> (2024)

Table 1: Variable Operationalisation and Measurement (Cont.)

Variable / Dimension	Measurement	Reference
Shari'ah Compliance (SC)		
Debt Compliance Ratio	Interest-bearing debt divided by total assets ($\leq 45\%$)	Financial Service Authority Regulation POJK 35/2017
Non-Halal Income Ratio	Interest revenue divided by total revenue ($\leq 10\%$)	Financial Service Authority Regulation POJK 35/2017
Islamic Financial Instruments (IFI)	Dummy variable: 1 = issues sukuk; 0 = otherwise	Financial Service Authority Regulation POJK 35/2017
Islamic Investment (II)	Dummy variable: 1 = no derivatives/short-selling; 0 = otherwise	Zain <i>et al.</i> (2024)
External Governance (EG)		
Regulatory Pressure (RP)	Dummy variable: 1 = issues sustainability report; 0 = otherwise	Harjoto & Wang (2024)
Social Pressure (SP)	Dummy variable: 1 = use of local workers/suppliers/unions; 0 = otherwise	Sun <i>et al.</i> (2025)
International Pressure (IP)	Dummy variable: 1 = compliance with GRI, ISO 14001; 0 = otherwise	Nie <i>et al.</i> (2024)
Creditor Pressure	Number of creditor banks	Guo <i>et al.</i> (2023)
Control Variables		
Firm Size	Natural logarithm of total assets	Zainuddin & Shari (2024)
Leverage	Total liabilities divided by total assets	Amosh <i>et al.</i> (2024)
Industry Type	Dummy variable: 1 = natural resource industry; 0 = otherwise	IDX Classification

Source: Authors' own

FINDINGS

Out of an initial population of 574 firms listed in the ISSI, the final sample consists of 155 firms with complete ESG and financial disclosures for 2023. **Table 2** presents descriptive statistics of the variables.

Regarding the environmental variables, **Table 2** shows that the average CE is 12,316 tonnes, which indicates that the companies in the sample still have emission levels that need to be controlled to achieve sustainability, while the average EE value of 0.015 implies that companies are relatively efficient in energy use.

On the social dimension, EW shows a minimum value of 11.39 and a maximum of 25.26, with an average of 17.91. This reflects the company's level of attention to employee welfare, which falls below the commonly cited 10 per cent benchmark in human resource management practice. CSI equals an average of 0.9, indicating that most customers are satisfied with the services or products provided by the company. WOB measures the percentage of women on the Board of Directors, and has an average of 0.16, reflecting the level of gender representation in the company's leadership, which is still relatively low. EOB records a mean value of 0.762, indicating that ethnic minority members represent a substantial proportion of board composition.

On the governance side, **Table 2** shows that the average company has a Board Independence (BCS) score of 0.39, indicating that most companies have an independent Board of Commissioners, exceeding 30 per cent. Ownership Concentration (OC) averages 0.53, indicating that the majority of shares in the company are owned by large shareholders. In

addition, the proportion of companies audited by Big 4 auditors is around 31 per cent. The frequency of audit committee meetings averages 6.99 times per year, reflecting a fairly active level of oversight of corporate financial performance.

Among the variables measuring firm value, it is found that Tobin's Q has an average value of 1,077.81, with a high variation from 0.17 to 12,343.44, reflecting significant differences in firm valuations. Similarly, Market-to-Book Value also shows substantial dispersion, indicating variation between market capitalisation and book equity across firms. ROA presents an average value of 0.598, while SPV records a mean of 0.03, representing the standard deviation of daily stock returns.

On Shari'ah compliance, IBDTA is shown to have an average value of 0.20, with a maximum of 3.63, which indicates that most companies have relatively low levels of interest-based debt. In addition, IRTR averages 0.059, indicating that the majority of companies in the sample have limited reliance on interest-based income. IFI has a mean value of 0.496, reflecting that approximately half of the sampled firms issue *sukūk*. Meanwhile, II has an average of 0.613, indicating the proportion of firms that comply with Shari'ah-based investments.

Regarding external governance, RP has a mean value of 0.942, indicating that most firms issue sustainability reports. SP and IP have average values of 0.766 and 0.810, respectively, reflecting the firm's engagement with local stakeholder practices and international sustainability standards such as ISO 14001 and Global Reporting Initiative (GRI). CP shows an average of 8.965 creditor banks per firm, representing the extent of external financing and pressure imposed by creditor banks.

For the control variables, firm size has a mean value of 27.987, while leverage averages at 0.409, representing the proportion of liabilities relative to total assets. Industry type shows a mean of 0.277, indicating that 27.7 per cent of the sample firms operate in the natural resources industry.

Table 2: Descriptive Statistics

Variable / Dimension	Measurement	Min	Max	Mean
Environmental (E):				
Carbon Emissions (CE)	Total CO ₂ emissions disclosed in the annual report	7.010	16.994	12.316
Energy Efficiency (EE)	Energy consumption divided by revenue	0.000	0.450	0.015
Social (S):				
Employee Welfare (EW)	Employee turnover rate	11.386	25.260	17.909
Community Engagement (CE)	Total CSR expenditure and charitable contributions	13.709	28.595	21.790
Customer Satisfaction Index (CSI)	Customer satisfaction index (0–1)	0.000	1.000	0.898
Women on the Board (WOB)	Ratio of female directors to total board members	0.000	0.667	0.161
Ethnic Minorities on the Board (EOB)	Ratio of ethnic minority directors to total board members	0.050	1.000	0.762
Governance (G)				
Board of Commissioners Structure (BCS)	Ratio of independent commissioners to total commissioners	0.000	1.000	0.390
Ownership Concentration (OC)	Ratio of shares held by major shareholders (>5%)	0.038	1.000	0.528
Audit Quality (AQ)	Dummy variable: 1 = Big Four auditor; 0 = otherwise	0.000	1.000	0.309
Audit Committee Meeting Frequency (ACMF)	Number of audit committee meetings per year	1.000	14.000	6.990

Table 2: Descriptive Statistics (Cont.)

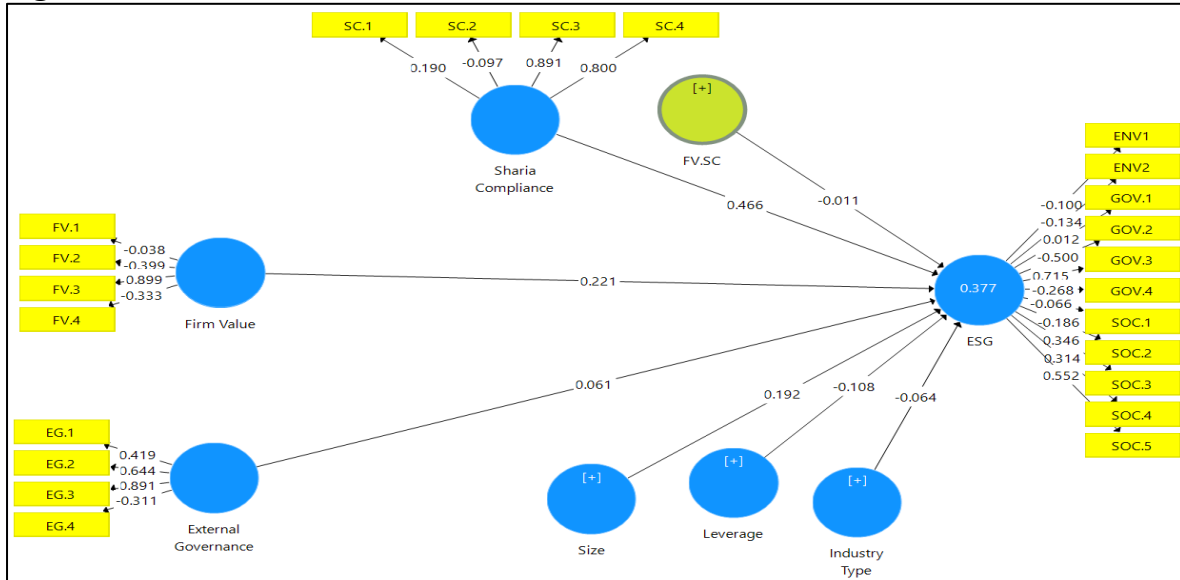
Variable / Dimension	Measurement	Min	Max	Mean
Firm Value (FV)				
Tobin's Q	Market value of firm divided by replacement cost of assets	0.172	12,343.44	1,077.81
Market-to-Book Value	Market value of equity divided by book value of equity	0.000	24,7060.02	6,592.82
Return on Assets (ROA)	Net income divided by total assets	-0.120	3.861	0.598
Stock Price Volatility (SPV)	Standard deviation of daily stock returns	0.003	0.237	0.030
Sharī'ah Compliance (SC)				
Debt Compliance Ratio	Interest-bearing debt divided by total assets - IBDTA ($\leq 45\%$)	0.000	3.633	0.200
Non-Halal Income Ratio	Interest revenue divided by total revenue - IRTR ($\leq 10\%$)	0.000	0.755	0.059
Islamic Financial Instruments (IFI)	Dummy variable: 1 = issues sukuk; 0 = otherwise	0.000	1.000	0.496
Islamic Investment (II)	Dummy variable: 1 = no derivatives/short-selling; 0 = otherwise	0.000	1.000	0.613
External Governance (EG)				
Regulatory Pressure (RP)	Dummy variable: 1 = issues sustainability report; 0 = otherwise	0.000	1.000	0.942
Social Pressure (SP)	Dummy variable: 1 = use of local workers/suppliers/unions; 0 = otherwise	0.000	1.000	0.766
International Pressure (IP)	Dummy variable: 1 = compliance with GRI, ISO 14001, or UNGC; 0 = otherwise	0.000	1.000	0.810
Creditor Pressure	Number of creditor banks	2.000	20.000	8.965
Control Variables				
Firm Size	Natural logarithm of total assets	19.282	35.178	27.987
Leverage	Total liabilities divided by total assets	0.001	1.965	0.409
Industry Type	Dummy variable: 1 = natural resource industry; 0 = otherwise	0.000	1.000	0.277

Source: Authors' own

HYPOTHESIS TESTING

Figure 1 shows the initial PLS-Path model. Indicators with outer loading below 0.50 were removed and the model was re-estimated to obtain the modified models as shown in **Figures 2** and **3**. Convergent validity was established with outer loadings exceeding 0.5. The Average Variance Extracted (AVE) scores also exceeded 0.5, following Hair *et al.*'s (2017) threshold. The square root of AVEs exceeding squared inter-construct correlations (Fornell-Lacker Criterion) and a heterotrait-monotrait ratio (HTMT) score of below 0.9 confirmed discriminant validity. Composite reliability (CR) further supported the model's reliability, with all scores exceeding 0.7.

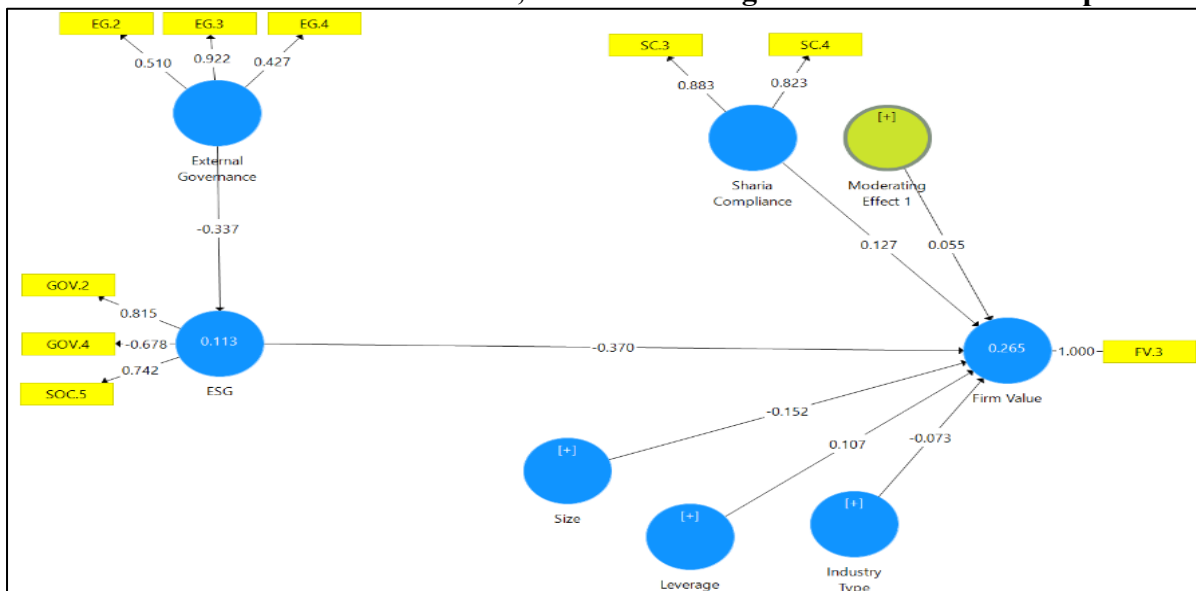
Figure 1: Initial PLS-Path Model



Source: Authors' own

Figure 2 shows the results for Hypotheses 1, 3, and 4. The path coefficient for the effect of ESG on firm value (Hypothesis 1) is -0.370, which is statistically significant. This negative relationship suggests that higher ESG implementation is associated with a decline in firm value. The R-square value for the firm value is 0.265, indicating that the structural model explains 25.6 per cent of the variance of firm value. The moderating effect of Shari'ah compliance on the ESG-firm value relationship (Hypothesis 3) yields a coefficient of 0.127, which is not statistically significant. This indicates that Shari'ah compliance does not significantly strengthen or weaken the impact of ESG on firm value. The path coefficient for the effect of external governance on ESG (Hypothesis 4) is -0.337, which is not statistically significant. This suggests that external governance mechanisms do not strongly influence ESG practices.

Figure 2: Modified PLS-Path Model – The Influence of External Governance on ESG; The Influence of ESG on Firm Value; The Moderating Effect of Shari'ah Compliance



Source: Authors' own

Regarding the control variables, firm size has a significant negative impact on firm value ($\beta = -0.152, p = 0.020$). This result may indicate that larger firms face greater market scrutiny, higher operational complexities, or diminishing returns to scale, leading to lower firm value. However, the effect of industry type, leverage and direct Shari'ah compliance on firm value are not statistically significant ($p > 0.05$), implying that these factors do not play a dominant role in explaining firm value variations in this dataset.

Table 3 summarises the structural model results for the hypothesised relationships in the ESG \rightarrow Firm Value model, including the direct effect of ESG on firm value (H_1), the moderating effect of Shari'ah compliance between ESG performance and firm value (H_3), and the influence of external governance on ESG (H_4).

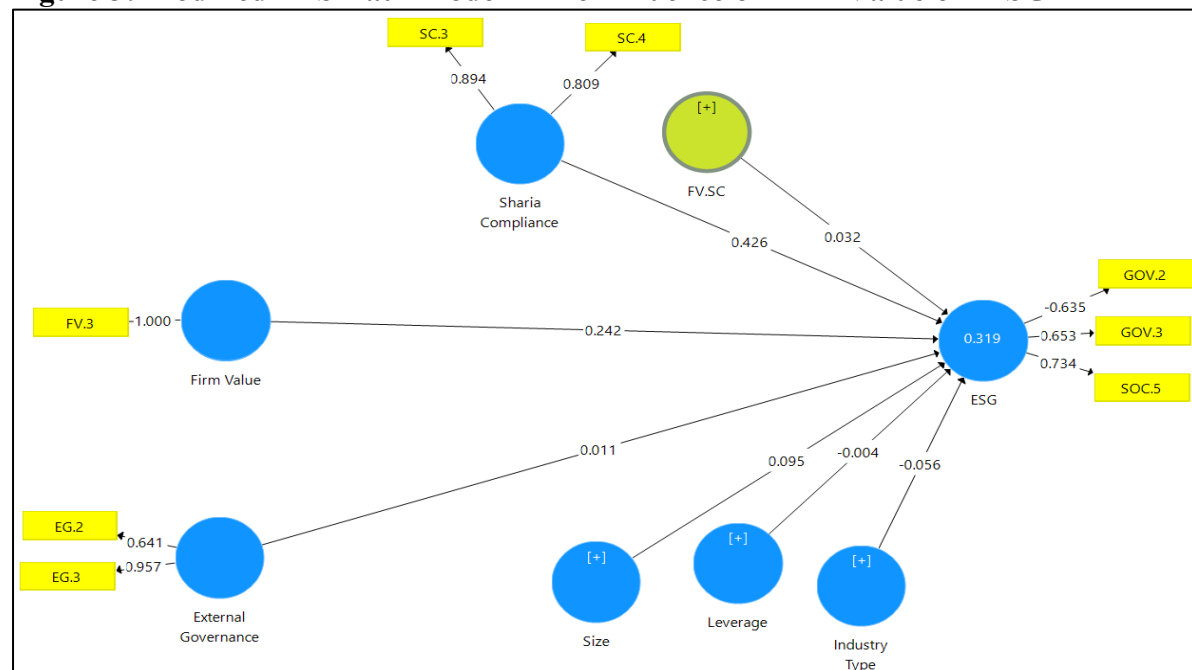
Table 3: Summary of Hypothesis Testing – ESG \rightarrow Firm Value Model

Hypothesis	Path	Std. Beta	Std. Error	t-value	p-value	Decision
H1	ESG \rightarrow Firm Value	-0.370	-0.377	6.243	0.000	Supported
H3	Shari'ah Compliance x ESG \rightarrow Firm Value	0.055	0.055	0.805	0.422	Not Supported
H4	External Governance \rightarrow ESG	-0.337	-0.3	1.595	0.111	Not Supported

Source: Authors' own

Figure 3 describes the result of testing Hypothesis 2. The results indicate a positive relationship between firm value and ESG ($\beta = 0.242$), suggesting that firms with higher firm value are more likely to engage in ESG practices. The R-square value for ESG is 0.319, indicating that the structural model explains 31.9 per cent of the variance of ESG. This finding supports the notion that financially robust firms have greater resources and incentives to invest in sustainability initiatives, as they are typically under higher scrutiny from investors and stakeholders.

Figure 3: Modified PLS-Path Model – The Influence of Firm Value on ESG



Source: Authors' own

In addition to the hypothesised relationship, the structural model results in **Figure 3** show that Sharī'ah compliance has a significant positive impact on ESG practices ($\beta = 0.426$, $p = 0.000$), suggesting that firms adhering to Islamic principles are more likely to integrate sustainability, ethical governance, and social responsibility principles into their business operations. This aligns with the fundamental values of Islamic finance, which emphasise fairness, environmental stewardship, and social justice, all of which resonate with the core aspects of ESG. The strong relationship also indicates that Sharī'ah-compliant firms may experience external pressures from investors, regulators, and stakeholders to uphold ethical and responsible business conduct, reinforcing their ESG commitments. **Table 4** presents the structural model results for Hypothesis 2, which examines the effect of firm value on ESG performance.

Table 4: Summary of Hypothesis Testing – Firm Value → ESG Model

Hypothesis	Path	Std. Beta	Std. Error	t-value	p-value	Decision
H ₂	Firm Value → ESG	0.242	0.109	2.229	0.026	Supported

Source: Authors' own

DISCUSSION

Impact of ESG Performance on Firm Value in Sharī'ah-compliant Firms

The results suggest that ESG has a negative impact on firm value, possibly due to the perceived cost of ESG investment (Desai, 2024; Hanh & Truong, 2023). Prior studies, such as those by Özer *et al.* (2024) and Zumente and Bistrova (2021), emphasised the strategic importance of ESG in enhancing a firm's reputation, attracting responsible investors, and supporting sustainable financial performance. The negative relationship suggests a complex dynamic within Sharī'ah-compliant firms. One possible explanation is that while ESG initiatives are ethically aligned with Islamic principles, they may also introduce substantial implementation costs that are not immediately compensated by market gains, particularly in emerging markets where investor understanding of ESG is still maturing. Fahad and Busru (2021) found that although sustainability disclosure can enhance firm value, such disclosures could simultaneously impair operational efficiency and return on equity (ROE), thus supporting the agency theory perspective that ESG investments can create cost burdens and managerial overreach. Moreover, when ESG practices are adopted primarily for compliance or reputation management, rather than integrated into long-term strategic objectives, they may be perceived by investors as merely symbolic actions. Fatemi *et al.* (2018) highlighted that firms may incur the costs of ESG implementation without experiencing corresponding valuation gains, particularly when disclosure practices are weak or inconsistent.

This scepticism may be compounded in the context of Sharī'ah-compliant firms, where investors may already expect high ethical conduct based on Islamic principles. As such, the introduction of ESG frameworks, without careful alignment with Sharī'ah values, may create a disconnect between stakeholder expectations and managerial actions, which could contribute to reducing investor confidence and firm valuation. In addition, ESG implementation may also be constrained by the requirement to avoid conventional financial instruments, such as interest-bearing debt, which are commonly used to fund sustainability projects. This limitation could restrict access to financing and inhibit the scale of ESG engagement (Haji Wahab *et al.*, 2024; Raimi & Abdur-rauf, 2024), thereby diminishing its perceived value contribution. Furthermore, despite the theoretical alignment between ESG and Islamic ethical standards, as highlighted by Saba *et al.* (2020), the market may not fully recognise or reward this synergy due to low ESG

literacy or transparency gaps in reporting. Consequently, even sincere ESG efforts may fail to reflect in higher corporate valuations. In addition, the emerging nature of ESG awareness and integration in Indonesian capital markets may limit the extent to which investors recognise or reward ESG practices. The market may not yet fully appreciate the long-term value potential of ESG performance, leading to short-term undervaluation.

Bidirectional Relationship between ESG Performance and Firm Value in Shari'ah-compliant Firms

The empirical results reveal a statistically significant positive relationship from firm value to ESG performance, suggesting that firms with higher market value are more likely to invest in and strengthen ESG initiatives. This supports the notion of a dynamic and reinforcing feedback loop, where financial strength provides the resources and incentives for companies to adopt sustainable practices. These findings also align with prior studies (Al-Khouri & Basith, 2022; Behl *et al.*, 2022), which argued that firms with stronger financial performance are better positioned to allocate capital towards long-term investments, including environmental innovation, social programmes and governance improvements. In the context of Shari'ah-compliant firms, this relationship may be even more pronounced, as financial capacity enables these firms to uphold both ethical and sustainability standards without compromising Shari'ah principles. Resource availability allows such firms to avoid interest-based financing and instead pursue ethical funding structures, further reinforcing alignment with ESG goals. This finding also supports Li *et al.* (2018), who argued that firm value can drive improvements in internal governance and sustainability as managers respond to stakeholder expectations and regulatory requirements more effectively when the firm is financially stable.

Moderating Role of Shari'ah Compliance in the Relationship between ESG Performance and Firm Value

The empirical analysis reveals that Shari'ah compliance does not significantly moderate the relationship between ESG performance and firm value among companies listed in the ISSI. One possible explanation lies in the overlap between Islamic finance principles and ESG standards. Islamic finance emphasises ethical investment, the prohibition of interest, and the exclusion of unethical sectors (Abbas *et al.*, 2024; Zain *et al.*, 2024). These principles are inherently aligned with the core pillars of ESG. However, the convergence of these two frameworks introduces complexity. As Haji Wahab *et al.* (2024) noted, Shari'ah-compliant firms must simultaneously fulfil Islamic legal and ethical standards while addressing broader global sustainability expectations, which can lead to conflicting priorities in practice.

Moreover, Katterbauer *et al.* (2024) highlighted that certain financing mechanisms commonly used to support ESG initiatives, such as debt instruments, may conflict with Shari'ah principles, especially due to the prohibition of interest-bearing loans. As a result, firms operating under Islamic financial guidelines may face limited options for funding large-scale ESG investments. This constraint can restrict their ability to fully engage in or benefit from ESG strategies, thereby reducing the moderating impact of Shari'ah compliance on the ESG–firm value relationship.

Influence of External Governance Factors on ESG Performance in Shari'ah-compliant Firms

The empirical results of this study indicate that external governance factors, such as regulator pressure, social pressure, internal pressure and creditor pressure, do not have a statistically

significant impact on ESG performance. This contrasts with past studies, which suggest that external forces are critical in shaping corporate sustainability behaviour. While regulatory frameworks and external stakeholder pressures are widely acknowledged as drivers of ESG performance (Yang *et al.*, 2024), their effectiveness may be more limited in Shari'ah-compliant firms due to the internalised ethical standards already embedded in Islamic business practices. According to Alessa *et al.* (2024), regulatory environments influence ESG engagement by enforcing disclosure standards or encouraging sustainable corporate behaviour. However, in contexts where Shari'ah compliance already mandates ethical investment and social responsibility, external regulations may not introduce additional incentives for ESG adoption. As Harjoto and Wang (2024) argued, the effectiveness of external regulatory pressure is contingent upon how well it aligns with a firm's internal governance and strategic priorities. Furthermore, pressures from creditors and financial institutions, which are typically strong motivators for sustainability adoption (Guo *et al.*, 2023), may have a more limited impact in the Islamic finance ecosystem. Shari'ah-compliant firms often avoid conventional debt instruments, relying instead on profit-sharing or asset-backed financing. As such, green credit guidelines or sustainability-linked lending practices that depend on conventional interest-based structures may not be relevant, thereby dampening the pressure these mechanisms exert on ESG performance. Similarly, public and societal expectations regarding ESG transparency may not sufficiently influence firm behaviour in this context. Shari'ah-compliant firms may already consider transparency and ethical conduct as part of their religious obligations, thus reducing the marginal influence of external societal pressure on their sustainability actions.

CONCLUSION

The results indicate that ESG has a negative and significant impact on firm value, suggesting that ESG investments may be perceived as costly initiatives that reduce firm value. This finding aligns with previous studies that highlight the challenges of ESG integration, particularly in emerging markets where investors prioritise financial returns over sustainability efforts. Firm value was found to significantly influence ESG performance, indicating that financially sound Shari'ah-compliant firms are more capable of pursuing sustainability objectives. This supports the view that economic strength enables greater ESG engagement, even within the ethical constraints of Islamic finance. Regarding the moderating role of Shari'ah compliance, the results show that Shari'ah compliance does not significantly influence the relationship between ESG and firm value. Lastly, the study finds that external governance does not significantly affect ESG performance. This implies that external governance mechanisms, such as regulatory oversight and stakeholder pressures, do not have a strong influence on corporate ESG commitments.

The findings of this study have far-reaching implications. Based on the findings, ESG integration, when supported by financial resilience, will strengthen long-term sustainability. ESG integration in the near term, however, may erode firm value due to the implementation costs and limited financial returns linked to sustainability projects. The analysis indicates the importance of the regulator developing incentive-based ESG frameworks in harmony with Islamic finance principles. The evidence also highlights the need to adopt incremental ESG strategies aligned with Shari'ah-based financing instruments. From an academic perspective, this study contributes to the ESG-firm value interplay literature by positioning Shari'ah compliance as a moderating factor, while highlighting compelling opportunities for further research in Islamic sustainable finance.

Future research should explore the long-term impact of ESG on firm value, considering different time horizons and economic conditions. Subsequent studies should also investigate

the role of investor perception in shaping the relationship between ESG and firm value, particularly in Islamic finance settings. Integrating qualitative approaches, such as interviews with corporate executives and policymakers, could provide a more comprehensive understanding of ESG implementation challenges.

This study has several limitations. First, the sample size is relatively limited, which may affect the scalability of the findings. Second, the study focuses on a specific market, which may limit its applicability to other regions with different regulatory and investor dynamics. Third, the study does not account for industry-specific ESG factors, which could influence the observed relationships. Future research should consider a broader dataset and industry-specific analyses to enhance the robustness of the findings.

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DECLARATION

Credit Authorship Contribution Statement

- **Sugiyarti Fatma Laela**: Conceptualisation of the research model, Methodology design, Data analysis, Interpretation of results, and Final review of the manuscript.
- **Rahma Wijayanti**: Manuscript drafting, Strengthening the analytical framework through in-depth literature review, and Editing of the paper.
- **Nur Hendrasto**: Initial conceptual development of the ESG framework and project presentation; Review.

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AI-assisted tools were used solely for initial language refinement. The manuscript was subsequently proofread by a professional native English speaker. All research content and analysis are the responsibility of the authors.

Data Availability

The dataset used in this study is available from the corresponding author upon reasonable request.

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